REPORT BY THE

AUDITOR GENERAL

OF CALIFORNIA

A REVIEW OF
THE DEPARTMENT OF FOOD AND AGRICULTURE'S
MANAGEMENT OF ITS MILK MARKETING PROGRAM

P-843 **MARCH 1990**

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April 6, 1990

P-843

Honorable Elihu M. Harris, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 2148
Sacramento, California 95814

Dear Mr. Chairman and Members:

We conducted a review of the Department of Food and Agriculture's (department) management of its milk marketing program. Overall, we found few weaknesses. However, one area within the program that needs improvement involves the prime interest rates that the department's staff used to calculate the allowances for returns on investment for processors of butter, nonfat dry milk (powder), and cheese.

The department defines an allowance for return on investment as how much money processors could earn if they invested their capital elsewhere at an investment of equal risk. The allowance for return on investment is one of the factors that the department considers when it establishes the minimum prices that processors must pay for milk. When calculating allowances for returns on investment, the department did not use weighted average prime interest rates that were in effect during the periods for which it was calculating. For example, in one instance, the weighted prime interest rate averaged 9.31 percent in 1988. Yet, the department used 11.5 percent, a 1989 prime interest rate. Because the department used inappropriate rates, it overstated processors' allowances for returns on investment and, therefore, may have established a slightly higher manufacturing allowance in July 1989 than it otherwise would have for milk used for butter and powder, and a slightly higher manufacturing allowance in August 1989 for milk used for cheese. As of February 1, 1990, these manufacturing allowances were still in effect.

The manufacturing allowance represents a processing cost per pound of converting milk into a finished product and an allowance for return on investment. To calculate the minimum milk prices, the department subtracts the manufacturing allowances from either the market prices or federal prices for butter, powder, and cheese. Using an overstated

manufacturing allowance results in lower minimum milk prices, thereby reducing the amounts paid to dairies for milk used to produce butter, powder, and cheese. As a result of our audit, the department has recently adopted a policy that states that the department's staff will calculate the allowances for returns on investment using a weighted average prime interest rate that corresponds with the time period studied.

Also, we found that the department investigated approximately 430 alleged unlawful trade practices from January 1, 1988, through August 15, 1989. The department investigated all complaints concerning unlawful trade practices that it received and confirmed that these practices occurred for 59 percent of the investigations. When it confirmed violations, the department ensured that nearly all of the violators took corrective action. Although the department's goal is to obtain voluntary compliance by the milk industry, the department filed civil actions against 18 alleged violators in 1989. The department did not file any other legal actions in either 1988 or 1989.

Finally, we present information on the department's sample selection procedures used when it conducts cost studies. The department uses accounting and other records at dairies and processors when it conducts its cost studies to calculate the minimum milk prices. The California Food and Agricultural Code allows the department access to processors' records. However, the department does not have access to dairies' records unless they are voluntarily supplied by the dairies.

BACKGROUND

Milk has three basic components: butterfat (fat), solids-not-fat, and fluid. The California Food and Agricultural Code categorizes milk, depending on its use, into five different classes. Class 1 is milk that is used for yogurt and fluid products such as lowfat and nonfat milk. Class 1 represents approximately 37 percent ($728 million) of the milk sold by dairies in 1988. Class 2 is milk that is used for cream, buttermilk, and cottage cheese. Class 3 milk is used for ice cream and other frozen products. Class 2 and Class 3 represent approximately 14 percent ($268 million) of the milk sold by dairies in 1988. Class 4a is milk used for butter and powder and Class 4b is milk used for cheeses. In 1988, Class 4 products accounted for approximately 49 percent ($943 million) of the milk sold by dairies. In July 1987, 133 California plants processed milk into various dairy products. Seventy-one plants processed milk into butter, powder, and cheese.

The State's policy, as set forth in the California Food and Agricultural Code, is to promote, foster, and encourage the intelligent production and orderly marketing of milk. Also, the policy states that the production and maintenance of an adequate supply of milk is vital to the public health and welfare. Further, the production, transportation, processing, and storage of milk is an industry affecting the public health. Finally, the State's policy is to eliminate economic waste and destructive trade practices in the milk industry.

To implement these policies, the department's director performs various functions. These include establishing the minimum prices paid for milk. Also, the department administers the Gonsalves Milk Pooling Act. The Gonsalves Milk Pooling Act authorizes the department to allocate milk revenues from milk sales among dairies. In fiscal year 1990-91, the department will allocate an estimated $2.4 billion from milk sales to dairies. The department also investigates allegations of unlawful trade practices, which are prohibited by the California Food and Agricultural Code. These practices include selling milk below cost and giving gifts to secure or retain milk business.

In fiscal year 1990-91, the department will receive estimated revenues of $6.25 million. The department also estimates that it will receive $100,000 from miscellaneous sources. The department will use these funds, totaling $6.35 million, to support the department's milk marketing activities.

<u>Minimum Prices for Milk Produced</u>

The California Food and Agricultural Code authorizes the department's director to establish the minimum milk prices paid for dairies' milk. The director establishes minimum prices for various components of milk for the five classes. The department sets monthly minimum milk prices for Class 4a and Class 4b and sets bimonthly milk prices for Class 1, Class 2, and Class 3. All processors must pay at least the minimum prices for the milk purchased. Before 1978, the director established the minimum wholesale and retail milk prices. Since that time, the department has only established the minimum prices paid for milk purchased from dairies.

The code requires the director to consider relevant economic factors when establishing minimum prices, including the reasonableness and economic soundness of milk prices in relation to the cost of producing and marketing milk. The minimum prices should also ensure an adequate

and continuous supply of milk at prices that are fair and reasonable to consumers. Finally, the prices for the various classes of milk should bear a reasonable and sound economic relationship to each other.

Periodically, the department issues documents called Stabilization and Marketing Plans (plans) that contain the formulas the department uses to calculate the minimum prices for the five classes of milk. The director may revise the formulas in the plans when needed. To amend the plans, the department conducts public hearings.

Using the formulas in the plans, the department calculates the minimum prices of Class 1 milk. The formulas include milk production costs, which the department obtains from dairies that participate in the department's cost studies. Milk production costs include feed costs, depreciation expense for dairy barns, other buildings, and equipment, and dairy operating costs.

Using the formulas in the plans, the department calculates the minimum prices of milk used for butter, powder, and cheese. The formulas include manufacturing allowances. A manufacturing allowance represents a processing cost per pound of converting milk into a finished product, such as butter, powder, and cheese, and an allowance for return on investment. The department defines an allowance for return on investment as a measure of how much money processors could earn if they invested their capital elsewhere at an investment of equal risk. The department calculates the allowance for return on investment by multiplying the book value of land, buildings, and equipment by the prime interest rate. The book value is the original acquisition cost minus any accumulated depreciation for the asset. The prime interest rate is the lowest rate of interest on bank loans offered to preferred borrowers. The Standard & Poor's Corporation publishes the prime interest rates in its current statistics report.

The director establishes minimum prices in each of the four marketing areas in the State: Southern California, Northern California, South Valley, and Del Norte-Humboldt. Between January 1987 and September 1989, the minimum prices for Class 1, Class 2, and Class 3 milk varied among the four marketing areas. However, the Class 4a and the Class 4b prices were uniform in the four areas.

SCOPE AND METHODOLOGY

The purpose of our audit was to review the department's milk marketing program. Specifically, we reviewed the department's procedures for calculating the processors' allowances for returns on investment for butter, powder, and cheese. We reviewed relevant state laws and certain Stabilization and Marketing Plans. In addition, we reviewed the department's manual on conducting cost studies for butter, powder, and cheese. We also reviewed the cost studies of butter, powder and cheese processors that the department used to calculate the manufacturing allowances for 1989. We obtained the prime interest rates that corresponded to the time periods of these studies. Further, we computed the weighted average prime interest rate for all processors during the time period studied. A weighted average prime interest rate takes into consideration the length of time that a particular interest rate is in effect. For example, interest rates that were in effect for a longer period of time have a greater impact on the resulting average.

Also, to provide information, we reviewed the department's enforcement of lawful trade practices. Specifically, we reviewed the relevant laws and regulations related to unlawful trade practices and determined the number of investigations conducted by the department. Further, we determined the outcome of the investigations, including the number of unlawful trade practices found. Furthermore, we determined the average number of days that the department used to close an investigation and the number of legal actions it filed for violations of lawful trade practices.

To provide additional information, we reviewed the department's sample selection procedures used when it conducts cost studies. We also asked the Legislative Counsel to determine whether the department's director has the authority to obtain accounting and other records from dairies. Also, we determined whether dairies voluntarily participated in the department's cost studies to determine milk production costs and whether the nonparticipating dairies have characteristics different from the participating dairies.

Further, we collected statistics on processors, including cooperatives, integrated retailers, and joint-venture processors. Also, we reviewed a court decision involving the allegations of illegal payments by a joint-venture processor. We present this information in the attachment to this letter.

Finally, we found no significant weaknesses with the department's procedures for determining the minimum prices of Class 1 milk. In addition, we reviewed the audit of the milk pooling funds performed by the department's internal audit staff. The department's audit included a review of the financial records and various procedures and internal controls used to process the funds. The internal auditors found no weaknesses with the Milk Pooling Program.

THE DEPARTMENT USED INCORRECT PRIME INTEREST RATES TO CALCULATE THE ALLOWANCES FOR RETURN ON INVESTMENT

The department conducts cost studies of processors of butter, powder, and cheese to determine manufacturing costs on a per-pound basis for products produced. The cost studies cover a 12-month period. Manufacturing costs include packaging expenses, processing expenses such as labor costs, and general and administrative expenses. The department also calculates the allowances for returns on investment when it conducts the cost studies. When selecting processors for the cost studies, the department selects a sample of processors that produce almost all of California's butter, powder, and cheese. It calculates manufacturing costs by reviewing accounting and other records and reviews the costs in accordance with the department's manual of auditing and cost procedures. The department uses only the cost of manufacturing cheddar cheese when determining the manufacturing costs for all cheese.

After summarizing each processor's costs for butter, powder, and cheese, the department determines, for all the processors in the study, the average manufacturing costs and the average allowances for returns on investment for butter, powder, and cheese. For example, in 1989, the department calculated the weighted average cost to manufacture cheese as $.2077 per pound and the weighted average return on investment as $.0247 per pound for the cheese processors studied.[1] The manufacturing costs ranged from a low of $.1367 per pound to a high of $.2849 per pound of cheese. The allowances for returns on investment ranged from a low of $.0043 per pound to a high of $.0417 per pound of cheese.

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[1]A weighted average in this instance takes into consideration the number of pounds of cheese produced.

Incorrect Prime Interest Rates

As discussed in the Background section of this letter, the department calculates the processors' allowances for returns on investment by multiplying the book value of land, buildings, and equipment by the prime interest rate. The department used the book value of the assets that corresponded with the accounting period studied. However, the department did not use the prime interest rates that corresponded with the time period studied. Instead, the department used the prime interest rates for the time when the department conducted the cost studies.

In our opinion, a reasonable approach for determining the allowances for returns on investment for a specific accounting period would be to use the weighted average prime interest rate that existed during that accounting period. However, the department miscalculated the allowances for returns on investment because it used prime interest rates that did not correspond with the accounting period studied. For example, in 1989, the department conducted a cost study of the manufacturing costs and the allowance for return on investment for a processor for calendar year 1988. When calculating the allowance for return on investment, the department computed the book value of the processor's assets for 1988, yet the department multiplied this 1988 book value by a 1989 prime interest rate of 11.5 percent. The department should have used a 1988 weighted average prime interest rate. During calendar year 1988, the prime interest rates ranged from 8.5 to 10.5 percent, changing six times during that year. If the department had used a 1988 weighted prime interest rate, the rate would have been 9.31 percent, a difference of 2.19 percent.

The department did not use a weighted average prime interest rate that corresponded with the period studied in any of its cost studies. Consequently, in 1989, the department overstated butter processors' prime interest rates by 13.8 percent, powder processors' rates by 14.5 percent, and cheese processors' rates by 15.1 percent. The following table presents a comparison of the prime interest rates used by the department with the weighted average rates the department should have used and presents the differences between the department's rates and the weighted average rates. The table also presents the percent of the prime interest rate overstated.

TABLE 1

COMPARISON OF PRIME INTEREST RATES USED BY THE DEPARTMENT WITH THE WEIGHTED AVERAGE PRIME INTEREST RATES THE DEPARTMENT SHOULD HAVE USED FOR BUTTER, POWDER, AND CHEESE PROCESSORS

Type of Processors	Prime Interest Rate Used by the Department	Weighted Average Prime Interest Rate	Difference Between the Department's Rate and the Weighted Average Prime Interest Rate	Interest Rate Overstated
Butter Processors				
A	11.00%	9.31%	1.69%	18.15%
B	9.50	8.45	1.05	12.43
C	10.00	8.66	1.34	15.47
D	8.50	8.18	0.32	3.91
E	10.00	8.66	1.34	15.47
F	10.50	8.88	1.62	18.24
G	10.00	8.74	1.26	14.42
H	10.00	8.88	1.12	12.61
I	9.50	8.59	0.91	10.59
J	9.50	8.45	1.05	12.43
K	10.50	8.99	1.51	16.80
Powder Processors				
L	11.00	9.31	1.69	18.15
M	9.50	8.45	1.05	12.43
N	10.00	8.66	1.34	15.47
O	8.50	8.18	0.32	3.91
P	10.00	8.66	1.34	15.47
Q	10.50	8.88	1.62	18.24
R	10.00	8.74	1.26	14.42
S	11.50	9.31	2.19	23.52
T	10.00	8.88	1.12	12.61
U	9.50	8.59	0.91	10.59
V	10.00	8.88	1.12	12.61
Cheese Processors				
W	11.50	9.31	2.19	23.52
X	9.50	8.45	1.05	12.43
Y	10.00	8.66	1.34	15.47
Z	11.00	9.31	1.69	18.15
AA	11.00	9.65	1.35	13.99
BB	10.00	8.59	1.41	16.41
CC	10.50	8.99	1.51	16.80
DD	10.00	8.74	1.26	14.42
EE	8.25	8.01	0.24	3.00

In 1989, the department's method of using prime interest rates overstated the allowances for returns on investment for every processor studied. For example, the department overstated the allowances for returns on investment for cheese processors by an average of 16 percent. The combined manufacturing costs and the allowances for returns on investment were overstated by an average of 1.5 percent as shown in Table 2.

TABLE 2

EFFECTS ON THE ALLOWANCE FOR RETURN ON INVESTMENT AND MANUFACTURING ALLOWANCE USING THE DEPARTMENT'S PRIME INTEREST RATES AND USING THE WEIGHTED AVERAGE PRIME INTEREST RATES THE DEPARTMENT SHOULD HAVE USED FOR CHEESE PROCESSORS

	Using the Department's Method (Per Pound)[a,b]	Using the Weighted Average Interest Rate (Per Pound)[b]	Percent Difference
Allowance for Return on investment	$.0247	$.0213	16.0%
Manufacturing Cost and Allowance for Return on Investment	$.2324	$.2290	1.5%

[a]This information was compiled by the department for public hearings held to amend the Stabilization and Marketing Plans. These plans became effective August 1, 1989.

[b]The amounts shown are weighted averages per pound of cheese.

The upward or downward movement of the prime interest rates during an accounting period would affect the results of cost studies. For example, if prime interest rates in the accounting periods reviewed were higher than subsequent prime interest rates, allowances for returns on investment would be understated using the department's method.

The Effects of Using
Incorrect Prime Interest Rates

The department used the overstated figures when it established the manufacturing allowances in the Stabilization and Marketing Plans effective on July 1, 1989, for butter and powder. The department also used the overstated figures for the cheese manufacturing allowance, effective on August 1, 1989. The overstated figures may have caused the department to establish manufacturing allowances higher than it otherwise would have, which, in turn, could have resulted in lower minimum milk prices, thereby reducing the amounts paid to dairies for milk used to produce butter, powder, and cheese. To calculate the minimum milk prices, the department must subtract the manufacturing allowances from either the market prices or federal prices for butter, powder, and cheese.[2]

Even though minimum milk prices may have been lower than they should have been, we are unable to ascertain the exact effect the overstatements of allowances for returns on investment had on the minimum prices. When establishing the manufacturing allowances, the department considered not only the data in the cost studies but other information. Other information includes the effects the manufacturing allowances could have on the supply of milk to Class 1 processors and the ability of processors to use all available milk for dairy products. Using the cost studies and other information, the department established the manufacturing allowance for butter at $.097 per pound, powder at $.16 per pound, and cheese at $.195 per pound. As of February 1, 1990, these manufacturing allowances were still in effect.

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[2]The formulas in the plans also require the department to include other factors when it calculates the minimum prices. The other factors are not affected by the manufacturing allowances.

Corrective Action

In a letter dated February 5, 1990, the department stated that it had adopted a policy requiring its staff to calculate the allowances for returns on investment for processors using a weighted average prime interest rate that corresponds with the time period studied. The department has revised its manual of auditing and cost procedures to include this policy. The department stated that the revised procedures will be used for all future cost studies of processors.

THE DEPARTMENT'S ENFORCEMENT ACTIONS TO PREVENT UNLAWFUL TRADE PRACTICES

The California Food and Agricultural Code states that the elimination of destructive trade practices is one of the State's policies for market milk. The code describes certain unlawful trade practices. For example, one unlawful trade practice is the extension to any wholesale customer of any special price or service that is not made available to all wholesale customers who purchase milk, cream, or any dairy product of "like quantity under like terms and conditions." Another unlawful trade practice is the giving of gifts, offers, or promises of milk, cream, or any dairy product, service, money, or articles of any kind, except to a bona fide charity, for the purpose of securing or retaining the milk, cream, or dairy product business of any wholesale customer.[3] A third unlawful trade practice is selling milk, cream, or any dairy product below cost. For processors and distributors, the code defines cost as the raw product costs plus all manufacturing, processing, handling, sale, and delivery costs, including overhead costs.[4] For wholesale customers, the code defines cost as the invoice or replacement cost, whichever is lower, plus the costs of doing business. However, the code does not prohibit a person from selling milk, cream, or dairy products below cost if the person is matching a lawful price of a competitor or a lawful competitive condition.

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[3]A wholesale customer is a person other than a distributor who buys milk, cream, or any dairy product for resale to consumers or to another wholesale customer.

[4]A distributor is any person who either receives, purchases, or acquires ownership, possession, or control of unprocessed milk for manufacturing, processing, sale, or other handling.

The department states that California laws are designed to promote fair milk marketing practices. Further, these laws are based on the concept that every wholesale customer who purchases a like quantity of milk or dairy products under like terms and conditions is entitled to the same price.

The department investigated approximately 430 alleged unlawful trade practices by various members of the milk industry from January 1, 1988, through August 15, 1989. Most investigations resulted from complaints from milk industry sources. The department investigated all complaints that it received. The most frequent types of complaints were that milk was sold below cost, special prices were provided, and gifts were given.

The department investigates the allegations of unlawful trade practices by reviewing documents such as accounting records and invoices. Further, the department may inspect the locations of alleged violations and may interview parties such as complainants and the accused persons.

After investigating the allegations filed from January 1, 1988, through August 15, 1989, the department found that, for 37 percent of the investigations, either no violation occurred or the department was unable to confirm a violation. For 59 percent of the investigations, the department confirmed that unlawful trade practices occurred. When it confirmed violations, the department ensured that nearly all of the violators took corrective action. The department uses various methods to determine that corrective action is taken, including visual verification and documentation of compliance. The remaining 4 percent of investigations are still pending.

The California Food and Agricultural Code does not require the department to complete its investigations within a specified time period. As of February 1990, the department used an average of 64 calendar days to close 43 investigations in our random sample. Our sample represents approximately 10 percent of the investigations opened from January 1, 1988, through August 15, 1989.

According to the California Food and Agricultural Code, persons who violate California trade practice laws are subject to civil penalties ranging from $100 to $1,000 for each violation. Further, the director may seek the issuance of a court injunction to prevent the violation or threatened violation of these laws. Finally, violators may be convicted of a misdemeanor punishable by fines or imprisonment. Although the goal of the department is to obtain voluntary compliance

from the milk industry, the department filed civil actions against 18 alleged violators in 1989. The department did not file any other legal actions in either 1988 or 1989.

THE DEPARTMENT'S AUTHORITY TO ACCESS ACCOUNTING AND OTHER RECORDS OF DAIRIES AND PROCESSORS

The following section presents information regarding the department's access to accounting and other records of dairies and processors. The department needs these records when it conducts its cost studies and then uses the cost studies to calculate the minimum milk prices. The department does not have access to the dairies' records unless they are voluntarily supplied by the dairies. However, the director may access processors' records.

Access to Dairies' Records

The department uses milk production costs of dairies, one component of the department's formulas, to calculate the minimum prices for Class 1 milk. The department obtains milk production costs by conducting cost studies of sample dairies. Milk production costs include cow feed costs, depreciation expenses of dairy barns and equipment, and dairy operating costs. As a part of these cost studies, the department reviews accounting and other records when voluntarily supplied by the dairies. The department summarizes the milk production costs from all dairies studied and then uses the summarized costs when it calculates the minimum Class 1 milk prices.

The department selects a sample of the approximately 2,100 dairies in the State to participate in the cost studies. If a dairy declines to participate, the department replaces that dairy with another dairy that voluntarily agrees to participate in the cost study. In 1989, the department conducted cost studies at approximately 400 dairies throughout the State. Periodically, the department replaces some of the dairies in its cost studies. For example, the department selected 284 dairies during 1987 and 1988 as possible replacements for its cost studies. One hundred eight-four dairies, or 65 percent of the selected dairies, declined to participate in the cost studies. According to the department, dairies do not participate for many reasons, including the dairies' unwillingness to participate in a voluntary survey.

With so many dairies not participating, we were concerned that the department's sample may not be representative of the State's dairies

and, thus, may bias the department's estimate of milk production costs. To determine whether the nonparticipating dairies affected the department's sample, we compared several characteristics of the participating dairies with the same characteristics of the nonparticipating dairies. Based on our sample of 32 dairies, we found that, generally, there were no statistical differences between a participating and a nonparticipating diary for the characteristics studied.

Dairies are not required by law to participate in the cost studies. The Legislative Counsel stated that the director may not require any dairy in the State to participate in the department's cost studies used to establish the minimum prices of milk. Further, the department may not examine the accounting and other records of a dairy unless the dairy voluntarily supplies these records. Furthermore, the Legislative Counsel believes that if the Legislature had intended to grant this authority to the director, it would have done so.

The department believes that the California Food and Agricultural Code does not authorize the department to require dairies to provide milk production cost records to the department. Also, the department believes that requiring uncooperative dairies to participate in cost studies would increase the department's costs. Further, the department believes that obtaining data from an uncooperative dairy is a difficult task. Finally, the department believes that the cost studies are an accurate measurement of the milk production costs and attempting to force uncooperative dairies to comply would not improve the cost studies.

<u>Access to Processors' Records</u>

The department conducts cost studies of processors' manufacturing costs. The department uses the manufacturing costs to establish the manufacturing allowances for butter, powder, and cheese. The department's method of collecting manufacturing costs and determining the allowances for returns on investment is described on pages 6 through 10 of this letter. The California Food and Agricultural Code allows the director access to processors' records. Specifically, Section 61442 states that the director may enter at all reasonable hours any place where any dairy product is being processed, bottled, stored, kept, or sold or where the books, papers, records, or documents pertaining to any transaction that relates to any dairy product are kept. Further, the director may inspect and copy such books, papers, records, or documents.

The department conducted cost studies at almost all major butter, powder, and cheese processors in California. According to the department, one cheese processor that processed 9 percent of the State's cheese refused to participate in the department's cost studies. This same cheese processor also processes a small amount of butter and is the only butter processor that refuses to participate in the butter cost studies. Although the department believes that it has the legal authority under Section 61442 of the California Food and Agricultural Code to force a processor to provide access to its records, the department believes that exercising its legal authority in court to do so would be expensive. Also, the department believes that cost information obtained from an unwilling processor under court order would not be as accurate or reliable as cost information obtained from cooperative processors.

Conclusion

When conducting cost studies of processors, the Department of Food and Agriculture miscalculated the allowances for returns on investment for the processors of butter, powder, and cheese. The miscalculations occurred because the department did not use weighted average prime interest rates that corresponded to the accounting period studied. The department used the miscalculated allowances for returns on investment and manufacturing costs, along with other information, to establish the manufacturing allowances for butter, powder, and cheese. Recently, the department adopted a policy to correct the miscalculated allowances for returns on investment.

Also, we found that the department investigated approximately 430 alleged unlawful trade practices from January 1, 1988, through August 15, 1989. The department investigated all complaints that it received. After investigating the allegations, the department confirmed that unlawful trade practices occurred for 59 percent of the investigations. When it confirmed violations, the department ensured that nearly all of the violators took corrective action.

Finally, the department uses accounting and other records of dairies and processors when it conducts its cost studies and then uses the cost studies to calculate the minimum milk prices. The California Food and Agricultural Code allows the director access to processors' records. However, the department may not examine the accounting and other records of a dairy unless the dairy voluntarily supplies them.

Recommendations

To improve its procedures for determining manufacturing allowances, the Department of Food and Agriculture should take the following actions:

- Revise its manual for conducting cost studies for butter, powder, and cheese to require its staff to use a weighted average prime interest rate that corresponds to the accounting periods studied;

- Use the weighted average prime interest rate to calculate the allowances for returns on investment for all future cost studies;

- Recalculate the allowances for returns on investment for the cost studies used to establish the current manufacturing allowances for butter, powder, and cheese; and

- Determine whether the existing manufacturing allowances are appropriate.

We conducted this review under the authority vested in the auditor general by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this letter.

Respectfully submitted,

Kurt R. Sjoberg

KURT R. SJOBERG
Acting Auditor General

Attachment

The Department of Food and Agriculture's response to this letter

GROWTH OF COOPERATIVES, INTEGRATED RETAILERS, AND JOINT-VENTURE PROCESSORS

The following section presents comparative information on California milk production, cooperatives, integrated retailers, and joint-venture processors. We compared selected statistics for calendar year 1980 with statistics for calendar year 1988.

COOPERATIVES

In California, 2,107 dairies produced approximately 17.6 billion pounds of milk in 1988. In 1988, all 12 cooperatives in California marketed nearly 86 percent of the dairies' milk or approximately 15.3 billion pounds. In 1980, cooperatives marketed nearly 55 percent of the State's milk or approximately 7.0 billion pounds. A cooperative, which is an association of dairies, acts for dairies and performs such transactions as the handling, sale, or delivery of milk. The primary objectives of cooperatives are to improve net returns to its members and to provide a reliable and consistent milk market. Seven of the 12 cooperatives owned and operated 14 milk processing plants. These 14 plants manufactured primarily butter, powder, and cheese.

INTEGRATED RETAILERS AND JOINT-VENTURE PROCESSORS

According to the department, all six integrated retailers and joint-venture processors in California sold nearly 35 percent of regular homogenized and lowfat milk in California in 1980. In 1988, all seven of these types of processors in the State sold nearly 43 percent, an increase of 8 percent. Integrated retailers own and operate both retail stores that sell dairy products and plants that manufacture dairy products. Joint-venture processors, consisting of two or more retailers, jointly own and operate manufacturing plants. However, integrated retailers and joint-venture processors usually do not operate their own dairies.

The remaining processors, who are neither integrated retailers nor joint-venture processors, sold 65 percent of the regular homogenized and lowfat milk in 1980. By 1988, other processors sold only 57 percent, a decrease of 8 percent.

In the early 1970s, the department challenged the legality of a specific joint-venture processor to operate in California. The department believed that the joint-venture processor provided its

stockholders with illegal payments of either rebates or kickbacks on milk sales. Rebates are discounts on the price of milk while kickbacks are secret payments. Both types of payments are unlawful trade practices as defined in the California Food and Agricultural Code. In 1973, the Los Angeles County Superior Court stated that this joint venture is a legal method for a small grocery store chain to join other small grocery store chains to establish a milk distribution operation under joint ownership. It allows small retailers to compete with integrated retailers. Further, the court determined that this joint-venture is not an illegal device for paying rebates or kickbacks to retail stores that are its stockholders.

STATE OF CALIFORNIA GEORGE DEUKMEJIAN, *Governor*

DEPARTMENT OF FOOD AND AGRICULTURE

1220 N Street
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February 21, 1990

Mr. Kurt R. Sjoberg
Acting Auditor General
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Dear Mr. Sjoberg:

This is to acknowledge receipt of your draft letter concerning "P-843 - A review of the Department of Food and Agriculture's management of its Milk Marketing Program." We have no significant disagreement with the draft report.

As you noted, the Department has already adopted the report's suggestion to calculate the return on investment using the weighted prime interest rate during the accounting, cost study period. In addition, the cost study manual has already been revised to incorporate this change.

It should be noted that the return on investment represents a relatively small portion of the total cost study. It reflects less than 10% of the total processing cost.

After receiving the report, the Department evaluated what effect the previous interest rate used to calculate the return on investment had on the establishment of the manufacturing cost allowances and ultimately the Class 4a and 4b price levels at the latest 1989 hearings. We concluded that it did not affect the decision on either the allowance or the price levels. Any potential problem in the return on investment calculation was largely resolved when the Department updated all cost data prior to the 1989 public hearing on Class 4a and 4b.

Your three-month evaluation of the Milk Marketing Program's performance was quite extensive. The problems mentioned in the report are relatively minor compared to the complex nature of the Milk Marketing Program. We appreciate your efforts to help improve the administration of the Milk Marketing Program.

Sincerely,

Henry J. Voss
Director
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